Expansion and Contraction from the Federal Reserve Standpoint

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IF kept clearly in mind, several facts will aid in an understanding of the problems which the Federal Reserve Banks have encountered in attempting to exercise an appropriate and scientific control over the expansion and contraction of both currency and credit. The United States is a country of immense extent, of the greatest diversity in its stages of development, in production and in the local availability of capital and investment funds. It is a comparatively new country and in the less developed sections banking is more of a business than a profession. As a nation we lack the beneficial influences of custom, precedent and the fruits of ancient experience. Instead of a homogeneous population, we have invited racial elements from every part of the earth, who have brought with them their own peculiar ideas and customs, all of which must be recognized from the standpoint of practical banking, and all of which tend to exert influences that retard the adoption of uniform practices and scientific banking methods. Bank management is of as diverse a character as the primary interests of the various states, and, broadly speaking, is a matter of adaptability to circumstances rather than the product of careful observance of economic law, sound financial principles and scientific methods. This thought might be summarized in the statement that banking is in a highly evolutionary condition in the United States, and that for the past ten years the period has been a transition from a rather archaic and outworn banking system to a modern and scientific mechanism, somewhat broader than banking itself, that will eventually provide the United States with the efficient system for banking, exchange and credit control which it needs as its equipment for a proper participation in the financial activities of the world.

POWERS OF RESERVE SYSTEM LIMITED

In the nature of things, the Federal Reserve System is not all-inclusive. The System embraces in it only the national banks of the United States, although the Federal Reserve Act also extends liberal privileges to the much more numerous state banks and trust companies. In membership,[1] the Federal Reserve System embraces 9,745

[1] U. S. Bank Figures—June 30, 1921.

	Total[a]	*In F. R. Sys.*[b]	*Per Cent Total*	*Out of F. R. Sys.*	*Per Cent Total*
No. of Banks	30,815	9,745	31.6	21,070	68.4
Capital	$2,904,511,000	$1,858,710,000	63.9	$1,045,801,000	36.1
Sur. & Undiv. Pf.	3,454,639,000	2,273,795,000	65.8	1,180,844,000	34.2
Total Resource	49,688,839,000	30,883,023,000	62.2	18,805,816,000	37.8
Loans & Dis. & Redis.	28,944,708,000	18,551,120,000	64.2	10,393,588,000	35.8
Investments	11,384,334,000	6,104,655,000	53.6	5,279,679,000	46.4
Bal. due from banks	4,795,387,000	2,978,276,000	62.1	1,817,111,000	37.9
Individual deposits	35,472,563,000	19,658,809,000	55.4	15,813,754,000	44.6
Nts. & Bills redis.	1,271,684,000	1,243,764,000	97.8	27,920,000	2.2
Bills payable	1,376,891,000	812,241,000	59.0	564,650,000	41.0

[a] Comptroller of Currency's Press Statement, October 31, 1921.
[b] Federal Reserve Board Report, June 30, 1921.

institutions out of 30,815 in this country, or 31.6 per cent. It includes 63.9 per cent of the banking capital of the United States; 65.8 per cent of the surplus and undivided profits, and it comprehends 62.2 per cent of the total resources, and was carrying on June 30 of the present year, 64.2 per cent of the loans and discounts, including rediscounts, of the country. It then held a little more than half of the individual deposits of the United States. With two-thirds of the membership and more than one-third of the resources of the banks of the country outside of the system, it is obviously impossible to expect it to exercise any complete control over expansion and contraction of credit. Its power over currency expansion and contraction is limited, due to the competition of other forms of money than Federal Reserve and Federal Reserve Bank notes.[2]

The rather powerful influence which the Federal Reserve System exercised during the war period, particularly since the radical advances in commodity prices, was fortuitous and due largely to the fact that under the country's pressing need for a sharply increased volume of currency with which to handle its current exchanges, its previously existing and rather inflexible issues were submerged to the extent that the overburden of Federal Reserve notes and Federal Reserve Bank notes became the dominating factor in the currency situation. This was due to the quick responsiveness of these notes to any demands for issue and the fact that they cannot be kept in circulation except in response to demand.

Another factor of great importance in connection with the whole question of expansion and contraction relates to the actual degree of power which the Federal Reserve System is able to exercise over its membership. Its powers are specifically indicated in the law[3] and are in the main of a general and supervisory character. The law seems to indicate quite clearly what specific rights a member in the Federal Reserve System enjoys, but limits in quite a distinct way the power and control over members to be exercised either by the Federal Reserve Banks or the Federal Reserve Board. In a certain sense and considering the subject purely from a practical standpoint, the real powers of a Federal Reserve Bank over its members are indirect and rise out of its contact and association with members at times when they are borrowing. It is difficult to see what very practical powers a Federal Reserve Bank might exercise over the non-borrowing element in its membership. Every Federal Reserve Bank has had such an element of rather substantial proportions throughout the war period. It is authorized to insist that its members maintain their capital stock at the figures fixed by law, that they carry unimpaired reserves and that they make appropriate periodic reports. It is divested of any power to control the policies or loan operations of members and has no authority whatsoever over the rates charged by a member to its customers.

It naturally has no powers of any

[2] The Secretary of the Treasury's Circulation Statement of October 1, 1921 shows gold coin and bullion, $903,163,000; gold certificates, $514,901,000; silver dollars, $75,388,000; silver certificates, $226,610,000; subsidiary silver, $261,602,000; treasury notes of 1890, $1,562,000; United States notes, $341,613,000; national bank notes, $728,314,000; or a total of $3,053,153,000 as compared with $2,518,963,000 of Federal Reserve notes and $119,163,000 of Federal Reserve Bank notes, or a total of $2,638,126,000 of Federal Reserve issues.

[3] See Section 13 of the Federal Reserve Act. Powers of Federal Reserve Banks—Section 11. Powers of the Federal Reserve Board—Section 4. Corporate powers of Federal Reserve Banks.

character over the numerous non-member banks, except that through wise leadership it may inspire the desire to conform to sound policies. In a period of inflation the rapid expansion of member banks' loans and discounts becomes a matter of first importance. Over such a rising tide of borrowings the power of a Federal Reserve Bank is limited. It can restrict, or, for cause, it might refuse the application of a member to rediscount; but its ability to control is largely centered in its position as an adviser in which it would employ the facts developed by its examiners and endeavor to create a clear understanding of all the factors which the situation might involve. In this capacity its value would be largely through wise suggestion and guidance.

There is therefore some question as to the degree of power to control which the Federal Reserve System has over even its own membership. Its real power, which cannot be denied, lies not in legal authorization or specific grant of regulatory authority, but in the confidence it can inspire because of sound leadership and the value it can give to membership because of the business advantages flowing therefrom. An important degree of voluntary coöperation has existed and extends far beyond the confines of its own membership, due to the enlightened self-interest of progressive institutions. It might be said that in a sense the Federal Reserve System, while it is an efficient organization, is more like a voluntary federation of common interests for their own good.

CURRENCY EXPANSION AND CONTRACTION

Not a great deal need be said of currency expansion and contraction as it relates to Federal Reserve issues. The mechanism by which this is accomplished is clearly stated in the law[4] under which each Federal Reserve agent in each Federal Reserve Bank, with the approval of the Federal Reserve Board, is authorized to draw from the Comptroller of the Currency and issue to his Federal Reserve Bank on the presentation of gold and proper collateral, Federal Reserve notes for issue to member banks. Upon the application of a member bank in good standing, accompanied by a tender of eligible paper for rediscount and credit, the Federal Reserve Bank in practice immediately delivers Federal Reserve and Federal Reserve Bank notes in such amounts as may be requested. The process of issue is therefore as nearly automatic as may be, and is properly founded upon the assumption that member banks will not request Federal Reserve issues unless they need them and that the necessities of their communities will rule.

Once issued, the Federal Reserve note moves through the member bank into the hands of the public and when it is no longer needed will find its way back into a bank. Banks which have accumulated more currency than they have use for, will remit to their correspondents or to their Federal Reserve Bank direct. The correspondents are largely members of the Federal Reserve System and the remittance of their excess accumulations is a matter of daily routine. Upon receipt by a Federal Reserve Bank, returned notes are sorted and under the law must be shipped at once for credit to the bank of issue. The particular Federal Reserve Bank has therefore no right of reissue except as to its own notes. Those consigned to other Federal Reserve Banks will reissue or not as the demand of that Federal Reserve District may indicate. If they do not re-

[4] Federal Reserve Act, Section 16. Note Issues.

issue, they are ordinarily returned for credit to the Federal Reserve agent or if worn and unfit find their way to early redemption and destruction. If fit, they are stored against the next period of demand. The method of retirement and redemption is therefore quite as automatic, although somewhat slower in process, than the method of issue. There can be no question but that the mechanism instituted under the Federal Reserve Act to create flexibility of currency expansion and contraction has operated with entire success, and that Federal Reserve notes possess these highly desirable qualities which were lacking in other currency issues of this government and in national bank notes.

The course of Federal Reserve note issues since late in 1920 has been downward. They reached their peak in November, when the aggregate issue was $3,349,000,000, and by October 1, 1921, declined to $2,518,963,000. This recession of $830,496,000 was as significant of the power of contraction inherent in Federal Reserve notes, as was the earlier rise indicative of their responsiveness to the issue demand.

In due time Federal Reserve Bank notes amounting to $119,163,000 will be retired. At a later date under provisions of the law, national bank notes (on October 1, 1921, amounting to $728,314,000) will likewise disappear from circulation. Treasury notes of 1890 are a small factor and their gradual retirement has been provided for by law. There will remain $341,613,000 of United States notes for which no retirement provision is included in the law, and the gold and silver certificates. It is therefore probable that with the gradual fall in Federal Reserve issues there will also be a gradual drift toward the elimination of competing factors in the circulation, with the ultimate result that Federal Reserve notes will control and currency will at last be upon a strictly flexible basis and will have the scientific basis which was contemplated in drafting the Federal Reserve Act.

The course of Federal Reserve note circulation in connection with the price movement during 1920 was very interesting. United States wholesale prices, based on the percentage of 1913 average prices,[5] reached their high point of 264 in May of that year. United States retail prices, based on the percentage of 1914 average prices,[6] held during June and July, 1920, at their high point of 215. The high point of Federal Reserve issues was reached during the last week of October[7] and the first week of November, or sixty days later than the peak of retail prices and since that time have steadily declined. The comparative curves tend to prove the accuracy of the view that currency expansion was the product and not the cause of price inflation and that currency contraction (Federal Reserve issues being the only issues having a real flexibility) was the natural product of the downward turn in prices. In paying cash for wheat at country elevators, it obviously takes more currency to buy wheat at the high point of more than three dollars than at the current price of about one dollar. In the agricultural districts the natural result is that member banks will request Federal Reserve notes in larger volumes during periods of rising prices and that their use for currency will fall off sharply on a declining market.

An important element in maintaining the flexibility and responsiveness of Federal Reserve issues to influences that tend to expand or contract them, is the fact that in current rediscounting

[5] Federal Reserve Board's Price Index.
[6] United States Bureau of Labor Statistics.
[7] *See* Footnote reference on page 178.

operations the larger part of Federal Reserve membership wants credit and not notes. Its demand for notes is wholly the product of local conditions and there is no occasion to request currency shipments unless the local currency supply is insufficient. Credit at the Federal Reserve Bank is more adaptable to its ordinary needs.

It may therefore be said that currency issues from the standpoint of the Federal Reserve Bank occasion practically no concern. They increase or diminish as the fluctuating conditions of each business day may indicate and their connection with such conditions is of the most intimate character. The rise and fall of Federal Reserve issues is so nearly automatic that it requires no extraneous suggestions or encouragement.

Credit Expansion and Contraction

The currency provisions of the Federal Reserve Act have proved a distinct achievement in financial legislation. The expansion and contraction of credit is not so simple a problem. In considering it from a Federal Reserve standpoint the membership figures of the System become in some respects more significant than other items of the consolidated bank statement of the country. Less than one-third of the country's banks are in direct contact with the twelve Federal Reserve Banks. Even this one-third may not be assumed to have continuous contact, since even during the recent period of very severe credit strain it has continuously included a substantial non-borrowing element with which the con-

[7] Trend of Wholesale and Retail Prices and Bills Discounted by Federal Reserve System and Federal Reserve Notes in circulation January, 1920 to September, 1921.

1920	*U. S. Wholesale Prices Per Cent of 1913 Average Price (Federal Reserve Board)*	*U. S. Retail Prices Per Cent of 1914 Average Price (U. S. Bureau of Labor Statistics)*	*Bills Discounted By Whole F. R. System on Last Reported Date in Month (000's Omitted)*	*Federal Reserve Notes in Actual Circulation Whole F. R. System on Last Reported Date in Month (000's Omitted)*
January	242		$2,174,357	$2,850,944
February	242		2,453,511	3,019,984
March	248	196	2,449,230	3,048,039
April	263	207	2,535,071	3,074,555
May	264	211	2,519,431	3,107,021
June	258	215	2,431,794	3,116,718
July	250	215	2,491,630	3,120,138
August	234	203	2,667,127	3,203,637
September	226	199	2,704,464	3,279,996
October	208	194	2,801,297	3,351,303
November	190	189	2,735,400	3,325,538
December	171	175	2,719,134	3,344,686
1921				
January	163	169	$2,456,475	$3,090,748
February	154	155	2,396,254	3,051,706
March	150	153	2,286,648	2,930,729
April	143	149	2,063,739	2,830,118
May	142	142	1,870,256	2,734,804
June	139	141	1,771,562	2,634,475
July	141	145	1,650,496	2,537,617
August	143	152	1,491,935	2,481,466
September			1,402,903	2,457,196

tact of the Federal Reserve Bank was of a limited and oftentimes of quite an indirect character. In this situation probably lies the seeds of the failure of the theory that a fluctuating rediscount rate is an engine for credit control.

Obviously Federal Reserve rediscount rates can control, if at all, only such banks as pay them, and such banks may not confine their borrowings to the Federal Reserve—in fact they seldom do. The influence of the rediscount rate must be of an indirect, and probably of a very tenuous character as to all non-borrowing banks, member or non-member alike. In most of the Federal Reserve Banks there has been some disappointment at the doubtful effectiveness of the rediscount rate in periods of rapid expansion of credit. To the man whose mind is fastened upon a prospective profit it is altogether improbable that an upward revision of one-half of 1 per cent in a rediscount rate which he does not pay directly, will tend to curb him or moderate his activities. Over the agricultural portion of the United States the bank rate of interest is as near to a stable rate as any example that the United States affords. In developed agricultural sections the tendency of the bank rate is to remain at practically the same level throughout the year, and, for that matter, over a period of years. The same tendency is noticeable in the less developed agricultural sections, although the rate levels are higher, and even where bank rates reach their highest levels the rate itself is subject to comparatively little change.

Where there are surplus capital and funds for investment, it is natural that the importance of agriculture should be recognized and that ample funds should translate themselves into fairly stable and relatively low rates to agricultural borrowers. The reverse, however, is not true. In the partially developed sections of the West it has been the habitual practice to attract outside funds by offering attractive rates on time deposits, which, once established, have automatically forced up the loan rate of the bank to its customers. Rates on time money change very little in western United States and they, more than any other factor, dominate and control the rate which must be charged to the borrower if the bank is to make a profit.

It would appear that the only points where the interest rate shows a proper responsiveness to the rise and fall of free funds is at the commercial centers or in the sections which have attained their development. In the very large western areas it has been noticeably true that the rate to the farmer and stock raiser has changed but little throughout the entire war period including the last twenty-two months of very severe strain on credit. This applies particularly to the best names. The availability of credit fluctuates more than the rate. Such a condition has not prevailed at the centers where the rate even to the best names has fluctuated in accordance with a changing money market. These were conditions which the Federal Reserve Banks were not called upon to encounter until after the war period of artificial prosperity had largely spent itself. It then became apparent that they entailed very serious problems, the gravest of which did not develop until the sharp fall in prices began to cause cancellations and extraordinary inventory losses, and to impair the credit standing of many responsible firms. In the stock-growing districts the market for wool collapsed. Live stock prices receded sharply. In the agricultural sections farmers who anticipated a continuance of the extremely profitable price levels saw corn drop to

a point where it was more profitable to burn it than buy coal; and wheat went down to a third of its high war price.

Reserve Bank Policy During Business Contraction

If every merchant and farmer caught in the jaws of this distressing situation had been improvident, lacking in foresight and not entitled to bank support and bank credit, the problem might have been easier. It would then have been simple to say that Mr. Smith and Mr. Jones had reaped the fruits of their own errors and to have permitted them to take the usual course through bankruptcy. The conditions, however, were somewhat different. While a certain amount of recklessness, extravagance and failure to consider the future, doubtless existed, price changes were so radical as suddenly to cripple and often seriously to embarrass, entirely worthy and reputable commercial, industrial and agricultural interests. It was necessary in such cases that the banks show no hesitancy in supporting every worthy borrower to the full extent of their power.

It is an interesting fact that this power to help was, to an extraordinary extent, based upon the power of the Federal Reserve System to extend credit. Access to the Federal Reserve Banks was a right enjoyed, under specific provisions of the law, by every member bank. There was, however, no legal bar to loans by city correspondents to non-member country banks, and the immediate result was that the very heavy rediscounting of banks at the centers was translated into equally heavy loans to non-member institutions at widely scattered points, irrespective of the provision of the Federal Reserve Act that denies the use of the credit facilities of the Federal Reserve System to non-members. There is no question but that the financial and business judgment of the country will strongly support the policies pursued by the Federal Reserve Banks when they are properly understood. A narrow or hidebound interpretation of the law, irrespective of the very great physical difficulties which must be encountered in any effort to trace the movement of the proceeds of rediscounts through a large city institution, would immediately have meant the failure of many hundreds of state institutions, a large proportion of which were, under the Federal Reserve Act, ineligible for membership because of insufficient capital. The strain upon the Federal Reserve System was severe enough and there could have been no justification for inviting the crisis which would have been precipitated had the very numerous non-member banks lacked a place to go to borrow.

What happened during the year ending April 28, 1921, is very interestingly shown in a chart prepared under the direction of Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York. Classifying all the members in the Federal Reserve System by their location in agricultural, semi-agricultural, and non-agricultural counties, we find that during this period the aggregate deposits of banks in non-agricultural counties fell off 4 per cent. In semi-agricultural counties the decrease was 5 per cent; but in the agricultural counties the decrease was 11 per cent. As to their aggregate loans, the decrease in non-agricultural counties was 6 per cent, and in semi-agricultural and wholly agricultural counties the decrease was in each case, 1 per cent. In their aggregate borrowings from Federal Reserve banks, non-agricultural counties fell off 29 per cent, while semi-agricultural counties receded only 2 per cent and wholly agricultural counties increased their borrowings 57 per cent. In aggregate

borrowings from other sources than the Federal Reserve System, the non-agricultural counties increased 1 per cent; the semi-agricultural counties, 19 per cent and the agricultural counties, 66 per cent. It therefore appears that agriculture, in which is included live stock, drew down its deposits, failed to decrease its loans, and in both cases made extraordinary increases in its borrowings.

A situation such as this was sure to produce peculiar problems in a Federal Reserve Bank. Let us suppose that in one of these agricultural sections a member bank had already increased its loans and discounts to the limit of safety while carrying reasonable rediscounts with its Federal Reserve Bank and substantial bills payable with correspondents. The long delayed liquidation in its territory fails to develop. Its farmer customers, perhaps five or six hundred in number, are man and man alike obliged to pay their debts contracted on a basis of high wheat and high corn, with wheat and corn having an abnormally shrunken market. Obviously the bank would fail in its responsibility to its community if it arbitrarily refused loans and forced payment. The facts were that in very numerous cases the enforcement of payment was practically an impossibility, since the crops lacked liquidating power. The Federal Reserve Bank's problem, therefore, became broader than that of the bank itself. It became a problem of carrying through the farmers or business men until they could again find a safe footing.

In some sections of the West it was necessary to continue this policy through four successive failures of the crop. The bank's alternative was to loan the minimum that was necessary to enable its customers to weather the storm or encounter a prompt insolvency. Within a very brief period fifty-three banks in a certain western state, and numerous banks in the South and in other portions of the country, mainly in districts that are agricultural, went to the wall. In such an emergency it is fruitless to rely upon the fluctuations of a discount rate. An increase of 1 per cent would not deter a bank in very grave difficulties from presenting eligible paper for rediscount at a Federal Reserve Bank. There can be no question of the legal right of a member in the Federal Reserve System to present eligible paper for rediscount. Upon the presentation of such paper the problem becomes one for the executive committee and executive officers to solve. They must determine whether in view of all the facts and circumstances the rediscount of particular applications is justifiable. I have indicated that during the recent abnormal period the justification of rediscount did not necessarily depend wholly upon the credit standing of the applicant or upon the character of the paper presented. Because of these conditions, which nullify the effect of discount rate changes, it is frequently necessary to carry a bank beyond what would ordinarily be considered safe or prudent limits in order to protect its depositors and its community and maintain the stability of the general banking situation. This has been particularly true where loans were "frozen" and slow rather than doubtful.

With a clean and reputable member under capable management in acute distress and faced with the alternative of obtaining additional assistance or closing its doors, there can be no question as to what the policy of the Federal Reserve Bank should be. It is better to save the reputable banks, assist their worthy customers, whether business men or farmers, to weather the storm, and hope for rehabilitation later, than

to take a narrow view and force the bank to the wall, unsettle public confidence and perhaps precipitate again such conditions as were a quite familiar experience prior to the establishment of the Federal Reserve System.

THE REDISCOUNT RATE AS CREDIT REGULATOR

Any discussion of credit control at the present time is necessarily colored by recent experiences and may perhaps have a less practical value because of the abnormal nature of the period from the beginning of 1920 down to date. Such a period does, however, carry its own lessons. One of the most important is that dependence upon the discount rate is a fallacy until the discount rate can be made generally applicable to the borrowings of all banking institutions in the country. Pending such development the real control of credit in the Federal Reserve System will lie not in the rate but in the accuracy and precision of judgment of the boards of directors, executive committees and executive officers in each of the Federal Reserve Banks, with the able leadership and excellent advice which they have unfailingly received from the Federal Reserve Board.

To the borrowing individual or borrowing bank, such strain and emergency destroy the effectiveness of control through the rediscount rate. The question then becomes one of expediency and safety and not one involving scientific application of a theory, which, while it works well in smaller and better developed nations, will have a doubtful practicability in the United States until it reaches equal development and has an equally well-knit population, properly seasoned by precedent, custom and established rule.

On the other hand, it cannot be doubted that the existence of a discount rate has been an influence of exceptional value. Some of the critics of its result in operation have apparently overlooked the fact that the Federal Reserve System during the period of the War was necessarily dominated by Treasury policies, and that it did not have an opportunity to work out a discount rate policy of its own. Within a very recent period a certain group of eastern banks encountering relatively the same conditions have gone to a flat 4½ per cent basis. A second group of banks, between the better developed East and the partially developed West, but having much the same problems to meet, have adopted a 5 per cent basis. The remaining banks in the undeveloped sections have gone to a 5½ per cent basis. We have therefore in the Federal Reserve System, for the first time, what is practically a uniform policy in the fixing of rediscount rates, and the new rates are as uniform as may be as to the districts where conditions are similar.

Under normal conditions there should be a differential between the developed East and the undeveloped West. Such a differential cannot always exist because it will be affected temporarily by stress and unusual developments in the money market. It has the merit of affording guideposts by which the 30,000 banks in the United States may judge country-wide credit conditions, and while their freedom and independence in making rates to their customers is in no wise impaired, it will unquestionably prove that Federal Reserve discount rates which maintain the proper relation between the different areas of the United States and which keep reasonably in line with their upward or downward movement, will have a very material indirect influence. They will probably tend in the long run to equalize bank rates in sections where conditions are similar and to prevent abnormal differ-

ences in the customers' rate in different sections of the country.

From a practical standpoint the control of credit is largely a matter of leadership and example. It is becoming clear that each rediscount application in a Federal Reserve Bank must receive a high degree of individual study and that there must be devoted to it a specialized judgment which takes full cognizance of all the facts surrounding it. In western Reserve Banks, at least, it is improbable that the conditions of any two borrowing banks will prove to be exactly parallel. These differences must be recognized and as they develop they call for keen banking judgment rather than the application of a rule. In the last analysis the control of credit through the Federal Reserve System is, therefore, a matter for the executive officers and executive committee in each individual case. They must set up their own policies, form their own judgments, and endeavor to hold all applications from borrowers to proper standards, which if they are to be valuable must not be inflexible. From an intimate viewpoint it is clear that the success the Federal Reserve Banks have had in enabling this country to avoid disaster, while not complete, was still extraordinary and that it had its foundations not in any question of rate control but in the application of shrewd and precise judgment to many thousands of separate and distinct problems.

In checking expansion, the promptness and courage of the Federal Reserve Banks in taking a stiff stand against inflation is likely to prove more efficacious than any decision to advance the rate, although both actions must go hand in hand. In reality it might be said that an advancing or receding discount rate is of material advantage as a warning signal but that the practical work of the Federal Reserve Bank is in its executive committee and that the degree of control which it exercises, which is necessarily limited by the insufficiency of its membership, will be proportionate to the farsighted vision and courage of the Federal Reserve Board, which supervises, and the executive control in each Federal Reserve Bank, to which each problem must ultimately come for settlement.

Principles Governing the Discount Rate[1]

By W. P. G. HARDING
Governor of the Federal Reserve Board

CONTROL over discount rates, as exercised by the Federal Reserve Banks and the Federal Reserve Board, is one of the most important and far-reaching powers ever delegated by Congress to another instrumentality. The grant ranks with the power given the Interstate Commerce Commission to regulate railroad rates. While it is necessary that powers of this kind should be vested in a few hands, they should be used with discretion and the effect of a change in rate should be carefully considered before the change is made.

The principle is well established that in theory the Federal Reserve

[1] Remarks at the opening session of the joint conference of the Federal Reserve Board with the Federal Reserve Agents and Governors of Federal Reserve Banks held at Washington, D. C., October 25–28, 1921.

Because of his official position, Governor Harding did not feel at liberty to express a personal opinion. In this paper, however, he states the problem as it has been brought before Federal Reserve authorities.